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A common characteristic of financial crises is that most market participants fail to anticipate them. If they did, the crisis wouldn't materialize, for the majority of market participants would take countervailing actions that, collectively, would mute the developing turmoil. Only a few see the storm approaching. The vast majority—after contributing to the making of the crisis in the first place—are caught off guard when the tempest hits, and suffer the consequences accordingly.

Henry Kaufman, *On Money and Markets: a Wall Street Memoir*
McGraw-Hill, New York, 1999

LIES, DAMNED LIES, WALL STREET

Policymakers and economists alike continue to implore the certitude of an impending soft landing for the U.S. economy, apparently assuming that any slowdown of economic growth implicitly bodes its yearned-for arrival, but that anything near enough to a temporary real shrinkage of GDP is completely impossible. The steep slide of the high tech stocks, the broad retreat of the Old Economy stocks, multiplying bank announcements of sharp increases in bad loans, the virtual shut-down of high-yield lending, record-high indebtedness of firms and consumers, an unsustainable negative personal saving rate, an unsustainable, monstrous current-account deficit and countless profit warnings—all these bigger and bigger economic and financial negatives, relentlessly eroding the U.S. economy's stability and strength, are flatly ignored by Wall Street's Panglossian economists.

What's more, the markets have readily and unreservedly embraced this shallow approach. But hasn't that very same intellectual shallowness been at the root of the Wall Street spin about a new paradigm economy and the ensuing, permanent equity bull market? The ugly reality rather is that never before in history has a major economy been so grossly out of internal and external balance like today's U.S. economy.

It's elementary, as a matter of fact, that hard landings essentially look soft when they start. When Wall Street first crashed in October-November 1929, it took more than a full year until the disappointing development of the economy and the stock market began to alarm people. Many had hailed the crash as a healthy shakeout of speculative froth. In Japan's case, the Bank of Japan raised its interest rate between May 1989 and August 1990 in big steps from 2.5% to 6%. While the Nikkei 225 peaked at end-1989, it took considerable time for these hikes to have visible effects on the economy. Despite plummeting stock and land prices, well into 1992 it looked like a soft landing for the economy. Real GDP growth was 5.1% in 1990 and still 3.8% in 1991.

Wall Street has canonized the U.S. economy's performance over the last few years as the greatest miracle in the history of capitalism. Massive investment in new high tech and new, superior corporate governance, so the story goes, have enabled Corporate America to deliver a productivity miracle—which, in turn, has provided for low inflation and superior rates of return on the invested capital, ratifying the ever higher stock prices that stimulate ever more productivity-enhancing capital investment. Bringing inflation under control allows interest rates to fall. This spurs capital investment; but more importantly, it provides a huge, permanent incentive for wealth holders to invest in equities. At the same time, the rising stock prices create the rising personal wealth that provides the impetus and also the purchasing power for higher consumer spending. In short: Keeping Wall Street and shareholders happy is *the* road to immense prosperity.

If the old sages of capitalism used to say that there are no gains without pains, such as saving, investing and laboring, the message of this new Wall Street model makes, of course, much more cheerful reading:

Consume and borrow as much as you can, and just buy stocks to get rich. This is an insult to economics.

EXPOSING THE "NEW PARADIGM"

Questioning the U.S. economy's new paradigm stance starts with a critical look at its recent growth performance. With real GDP growth averaging 5% per year, the U.S. economic expansion has definitely outpaced the rest of the world. But there was nothing unusual about these growth rates. What rendered the special glow to this performance was only the favorable comparison with lagging economic growth in Europe. During Japan's bubble years, its real GDP grew at an annual average rate of 5.5%.

The real shocker, however, is a comparison of inflation rates. While Alan Greenspan and Wall Street keep extolling America's low inflation rate as one of the great attributes of the new paradigm economy, it is, incongruously, the highest inflation rate among the major industrial countries, now exceeding 3.5% and averaging about 3% per year since 1995, as against a rate of persistently less than 1% during Japan's bubble years. If not for the numerous downward adjustments in the consumer price index, the strong dollar and the huge import surplus, U.S. inflation today would be closer to 5% at annual rate.

And there is not a trace of a new paradigm in the U.S. economy's profit performance, as measured by the official data. See the table in the last letter (page 2), taken straight from the Commerce Department's Survey of Current Business (August). These numbers, we said, expose the prevailing Wall Street and Greenspan hyperbole about the New Economy as complete rigmarole. What do we think of the integrity and the soundness of the analytical work of those thousands of economists and analysts who flatly ignore the grossly contradicting numbers from official sources? We suspect the existence of these numbers is unknown to most of them.

Looking at the U.S. inflation and profit figures, we can't help to conclude that the new paradigm image of the economy has very little to do with macro- and microeconomic reality. It's Wall Street fiction, 100%. What, though, about the steep rise in productivity growth over the last few years? We shall come to that a bit later in this letter. For the time being, just one remark: The beauty of the productivity numbers is flatly incompatible with the poor inflation and profit numbers.

COULD THE HARD LANDING ALREADY BE HERE?

In the last letter we warned, "all signs point to deepening weakness in the economy and, in particular, to a progressive profit squeeze." The most recent data are depicting an economy that is slowing so dramatically that we are beginning to wonder whether the U.S. economy's hard landing has not already arrived, implying zero or less than zero economic growth in the fourth quarter.

Saying this, our special attention is focused on the two demand components that have overwhelmingly propelled U.S. economic growth in the course of the current year. They are consumer spending and inventory building. In October, real disposable personal income declined .6%, and real consumer spending was flat. At the same time, inventory building has sharply slowed.

Nevertheless, there is sure to be a strong, seasonal rise in consumer spending from its levels in the third quarter, but in order to translate into new GDP growth, it has to be stronger than in the past years. It would astonish us if it is.

Meanwhile, bad news from the retailers themselves is abounding. The only question to many of them seems to be whether the holiday shopping season will be merely mediocre or downright disastrous. Yet as if retail sales were of little economic relevance, aggregate growth forecasts for the U.S. economy remain stubbornly on the high side. Anything below the pace of 3% at annual rate seems to be beyond the imagination of most people.

THE GREAT ILLUSION

Above all, the conviction that the economy is safely on track for a soft landing without recession appears to be still unquestioned. Rather than worry about weak economic data, these figures are still hailed as good news countering further rate hikes. The common arguments against the possibility of a recession are chiefly (1) that recessions only happen when rising inflation compels a central bank to immoderate monetary tightening; and (2) that the ingenious Mr. Greenspan will, in any case, save the day by rapid monetary easing, should the economy slow more than desirable. In turn, prompt rate cuts, for most American economists, are the infallible guarantee for the soft landing.

Many times in the past, we have made it clear that we radically disagree with this view that attaches supreme importance to low inflation rates both as a measure of economic health and as an insurance against recession. Ironically, it is a historic fact that the worst recessions and even depressions in history have happened in the wake of prolonged periods of low inflation.

America had zero inflation during the 1920s, and Japan's CPI during the bubble years of 1988-89 kept below 1%. In light of these experiences, it is a badly flawed argument that the low inflation rate in the United States is proof of the absence of an asset bubble. Ironically, America's current inflation rate of 3.7% is actually very much on the high side in the present international environment. Many other central banks, among them certainly the European central bank, would regard this inflation rate as too high for comfort and therefore a compelling cause for monetary tightening.

While this sequence of low inflation rates and following deep recession or depression may at first sight be bizarre, it has its compelling logic. Low inflation rates constitute the indispensable condition that misleads central bankers to close their eyes to the developing excesses in money and credit creation that generate the asset inflation in the first place and, over time, the bubble economy.

What, then, is it that tends to make inflation rates an unreliable guide for monetary policy? The principal reason is that inflation rates are affected by too many influences other than money and credit expansion. Think of the strong dollar and the huge U.S. trade deficit massively diverting domestic American demand to foreign producers.

WHEN ASSET BUBBLE TURNS INTO BUBBLE ECONOMY

It is the central axiom of Austrian theory that credit excesses—meaning a credit expansion in excess of available domestic savings—set in train unsustainable borrowing and spending binges implementing unsustainable changes in the pattern of demand and production which may not at all show in the inflation rate. But once the ongoing credit and debt expansion fails to keep up with the rapidly rising credit requirements of the economic and financial boom, the asset bubble and the distortions in the economy begin to unravel.

The typical imbalance in the short-term business cycle used to be excessive inventory accumulation. Depending on its size, the liquidation of the stockpiled goods and related debts could be quite sharp and painful. But resulting recessions were always of very brief duration. Ironically, American economists like to emphasize that the traditional business cycle is a thing of the past because computerized real-time monitoring of inventories is preventing production from ever again getting too far ahead of sales.

We shall soon see whether this is true. During the past months, as a matter of fact, heavy inventory building has been masking sharply weakening final demand. The irony of it all is that inventory excesses, for the reasons explained, are in reality the most harmless kind of imbalance that an economy may incur. In essence, they represent *the* typical short-term, *cyclical* economic imbalance, making for sharp but very brief recessions.

Far more dangerous and far more enduring in their negative effects on the economy, as well as far more difficult to correct, are the distortions and imbalances that credit and debt excesses impart to the financial system and to the pattern of consumer spending and business fixed investment.

Their corrections are much more painful and much more protracted. The particular danger of asset price bubbles rests in the fact that the soaring asset prices inherently provide ever more collateral value for more and more borrowing and spending by businesses or consumers. "Backed" by the bubbling asset prices, credit excess feeds into higher and higher asset values. If monetary policy accommodates these excesses, the business cycle essentially develops into the self-feeding, precarious Bubble Economy. Prolonged credit and debt excesses of extraordinary scale, essentially, result in extraordinary imbalances in the economy and the financial system.

In the case of Japan, the bubble-bred borrowing and spending mania went overwhelmingly into investment spending on commercial real estate and plant and equipment. The most conspicuous feature of the developing Bubble Economy was a soaring financial deficit in the corporate business sector, being the measure of spending in excess of cash flow. At the bubble's peak in 1990, this deficit on the part of Japan's business sector equaled 9% of GDP, as against an average deficit of about 3% in the 1970-80s. Remarkably, this extraordinary investment boom was more than fully matched by personal savings running at almost 10% of nominal GDP. With the government sector equally in financial surplus, Japan's booming economy continued to run a substantial trade surplus.

On the surface, Japan's economy appeared to be in healthy equilibrium. However, corporate investment spending had grossly outpaced consumer spending. In essence, overinvestment became malinvestment. In the same vein, the bubble-bred credit and debt excesses had ravaged the financial structures of borrowers and lenders. When the bubble burst, the crashing stock and land prices simply devastated the collateral to these loans, leaving behind corporations and banks with appallingly overextended balance sheets.

THE GENESIS OF ALL CRASHES

America's bubble experience has been of a diametrically different pattern. An important difference rests in the fact that the borrowing and spending mania in America has involved both corporations and consumers, and it's hard to decide which of the two has been the more reckless participant. Four figures, covering the five-and-a-half years from end-1994 to mid-2000, highlight the making and the scale of the U.S. bubble:

(1) nominal gross domestic product up $2,720 billion;
(2) corporate and consumer indebtedness up $4,750 billion;
(3) indebtedness of the financial sector up $4,150 billion;
(4) total credit and debt creation up $8,900 billion.

In sum, total GDP growth of $2,720 billion compared during this period with overall credit creation of $8,900 billion. This is not just another Bubble Economy. It's by far the worst of its kind in history. To accommodate such a credit explosion for such a long time, it needs one of two things on the part of the central bank: absolute recklessness or absolute ignorance in matters of credit and money. In the second quarter of 2000, by the way, consumer and business borrowing hit a new all-time record of $1,400 billion at annual rate.

The most conspicuous feature of the U.S. asset bubble has been its whopping effect on personal saving and consumption. A gradual, apparently cyclical, decline of current saving that started in 1992 abruptly turned into a vertical plunge in late 1998. Over the six years up to then, personal saving had shrunk from a peak rate of 8.7% to 4.1% of disposable income, reflecting a decline from $413 billion to $265 billion per annum. Over the following 20 months, this decline accelerated dramatically. Involving a total amount of about $300 billion over this short span of time, it propelled the saving rate significantly into negative territory.

Looking for the event that triggered this sudden, prolonged wave of massive consumer dissaving, the Fed's three rapid rate cuts in response to the Asian-Russian crisis are the obvious explanation. Manifestly, this sudden stampede of the American consumer out of current saving has been the U.S. economy's chief propellant over the last two years. In this respect, it definitely is a new paradigm economy. This has no parallel in history.

PERSONAL INCOME AND OUTLAY
CHANGES FROM PRECEDING QUARTER (IN $BILLION)

	1999				2000		
	I	II	III	IV	I	II	III
Disposable personal income	94.1	96.1	68.2	110.5	91.5	98.4	81.1
Outlays	127.5	109.4	110.5	130.8	181.5	91.7	111.1
Saving	-33.4	-13.3	-42.3	-10.9	-90.0	5.4	-28.4
Real disposable income	69.7	58.4	56.9	84.4	43.9	21.9	63.3

Source: Survey of Current Business, Department of Commerce

What do you think of these numbers? The bulls, clearly, yearn to see a slowing U.S. economy. But not too much of it, please. For many, the 2.4% real growth rate for the third quarter looked already a bit too much of a good thing. What was responsible for the sharp slowdown from 5.6% in the prior quarter were three demand components: inventories, fixed investment and government spending.

The growth contribution of inventory accumulation fell from 1.73 to -.18 percentage points of GDP and that of fixed investment from 1.93 to .58 percentage points. Federal spending even subtracted 0.63 percentage points from GDP growth in the third quarter, after adding 0.97 percentage points in the second quarter. The main source of strength was another burst in consumer spending. Stressing the role of the sharp reversal in government spending, commentators generally argued that the economy was stronger than the low aggregate figure seemed to suggest.

FUDGING THE BOOKS?

Convinced that the U.S. economy is at its most critical juncture, we keep minutely scrutinizing all new data. Yes, we agree, the numbers are highly deceptive. What we observe, however, is a lot more hidden weakness than hidden strength. The most ominous is the ongoing heavy build-up in business inventories. True, it has added very little to the GDP growth in the third quarter. Yet inventories effectively increased again by a stellar amount of $73.8 billion, after $78.6 billion in the second quarter and $36.6 billion in the first quarter. But the point to see is that only the marginal increase of $1.3 billion enters the GDP growth calculation.

Moreover, we have serious reservations about the recorded changes in government spending. Looking over the GDP numbers for the second quarter, a sudden jump in federal military spending, adding 0.97 percentage points to real GDP growth, struck us as rather strange. Was that spending burst just coincidental or deliberate, we wondered. In its absence, real GDP growth would have been 4.6% instead of 5.6%. We decided to take a close look at the third-quarter GDP numbers.

Federal spending duly fell, though much less than the prior rise. However, there was a distinct twist in the comments to the numbers. While nobody had bothered to mention the big contribution of federal spending to GDP growth in the second quarter, it was commonly stressed that the economy's slowdown was exaggerated by the sharp fall of government spending.

Actually, the Treasury furnished another big spending dose in September, amounting to $60 billion at annual rate. This time it was for agricultural subsidies. As federal spending nevertheless diminished GDP growth in the third quarter, there must have been bigger offsetting declines in other kinds of spending. While the GDP report

for the third quarter passed over this subsidy boost in silence, it came to light in the consumer income and spending report for September, showing a big leap in personal income growth to $90.3 billion, after $32.4 billion in August and $22.9 billion in July.

There is no question that the U.S. economic picture has been grossly distorted for the better. Deliberate fudging or not? That's the question. Weighing this question, it has to be realized that a certain statistical practice, unique to the United States, is highly conducive to such distortions. It is the practice to annualize changes in certain monthly and quarterly data. In the second quarter, as we mentioned, federal spending added a big chunk of fully 0.97 percentage points to U.S. real GDP growth. The actual increase was only $22 billion. But courtesy of annualization, it was quadrupled in the GDP calculation. (Our computer didn't know the word "annualization" and proposed instead "cannibalization." It certainly cannibalizes economic reason.) Such statistical snags were harmless as long as only economists took interest in these numbers for their research. In a world where investors around the world are obsessed with them as their guide for investment, they can perfidiously mislead.

WEAKNESS ACROSS THE BOARD

After all, we can only emphasize our repeated warnings that the U.S. economy is considerably weaker than the consensus believes and the GDP data suggest. If it were not for the heavy inventory building and the big federal spending injections, there would now be talk of recession. What's more, there is now economic sluggishness across the board. A single spot of strength in the third quarter was consumer durables with an increase of 7.5%. But this followed a plunge of 5% in the preceding quarter.

The sharp reversal in fixed investment spending in the third-quarter numbers makes ominous reading. The increase in the nonresidential component slowed from a rate of 14.6% in the second quarter to a rate of 7.8% in the third quarter. This is well below the average in the current expansion. Investment in equipment and software decelerated from 17.9% to 5.8% at annual rate. Residential investment even fell 10.5%, in contrast to a prior rise of 1.3%. For an economy that is supposed to be booming, these are pretty dramatic declines.

The bulls take strange comfort from the fact that the heavy losses in the stock market have not prevented the consumer from extending his borrowing binge. We would say that an economic expansion, driven by a literal collapse in personal saving, is neither a particularly healthy nor, at any rate, a sustainable growth pattern. Most importantly, bad profit news is proliferating.

After analyzing the growth pattern in the third quarter in the last letter, we concluded that the U.S. economy is considerably weaker than the aggregate data seem to suggest. To repeat, the only source of strength was consumer spending on durables, largely reflecting aggressive discounting by the automobile industry. In addition, considerable false strength derived from heavy general inventory building and the big federal payment for agricultural subsidies.

HERE COMES CONSUMER TROUBLE

What next? What is going to happen on the demand side in the fourth quarter and thereafter? Essentially, we can only guess. Still, there have been distinct developments in the third quarter that give important clues. Principally, it all boils down to three chief questions:

First, what is the probability that the consumer continues his massive dissaving, spending more then he earns? Second, what is the probability that fixed investment spending recovers from its weakness? And third, what will happen to inventories?

As to the consumer, two considerations above all have led us to presume that significant dissaving is

probably done with. New saving may soon begin to sprout, and this would in sequence imply sharply weaker consumer spending. Savings are already in negative territory. What weighs most in our critical considerations, however, are the consumer's escalating financial woes: rapid erosion of former stock market wealth on one hand and rapid erosion of real disposable income growth on the other.

For sure, given the big losses in the stock market and the painful erosion in real disposable income growth, consumer confidence has held up surprising well. But who is telling the consumer that the economy is heading for greater trouble and that his hopes for a return of the bull market are grossly misplaced? The consumer's unshaken confidence only reflects Wall Street's trumpeted unshaken confidence.

Yet he meanwhile feels the pain of losses in his wealth and in dramatically slower income growth. Nevertheless still full of confidence, he may well regard this retrenchment as just temporary. However, the news from the retail sector is rapidly going from bad to worse. See the article in *Business Week* (Dec. 4, 2000) "'Tis the season to be gloomy." To quote from the article: "The growth rate of sales has slowed steadily since hitting 7.3 % (compared to a year ago) in summer. All told, retail sales excluding autos and gasoline will likely grow just 4.5% in the fourth quarter. That's the slowest pace since 1995 and far below the blockbuster 8.9% of a year ago... Sears Roebuck & Co., for one, says it will have more promotions and will run them earlier in the season... With such measly gains, 'tis the season for a brutal market-share battle."

In order to put those numbers about the expected increases in retail sales in the fourth quarter into perspective, it has to be considered that the year-over-year volume increase has been 6.5% in September. Consider further that consumer spending, against the background of literally exploding stock prices, accounted for 4.08 percentage points in the fourth quarter of last year and even for 5.03 percentage points of real GDP growth in the first quarter of 2000.

It is often argued that the credit figures do not show any consumer retrenchment. This view overlooks that this ongoing borrowing binge has effectively two different causes. Accelerating spending is one; sharply slower growth in real disposable income is the other. A growing part of the new borrowing has to compensate for the sharp decline in income growth. In 1998, an increase in real consumer spending of 4.4% was matched by an increase in real disposable income of 4.8%. In 1999, this relationship was 5.4 to 3.1, and in the third quarter of 2000 it was 4.5 to 2.5. However, more than half of that income growth had come from the farmer subsidy payment mentioned earlier. In other words, it requires more and more borrowing for less and less spending growth.

Considering these highly adverse income and stock market conditions facing the consumer, we find it absolutely impossible to conceive of still higher borrowing and spending on his part in the foreseeable future. What he actually needs is a substantial income improvement, which is not in sight. Rather we see that decreasing spending is, in turn, decreasing income growth, which will essentially diminish still high-riding expectations, so that the process becomes cumulative. If not from higher government spending, a new impetus would have to come from higher private fixed investment spending or higher exports. Neither of the two looks possible, let alone probable. As to business investment, it looks more poised for a slump.

HERE COMES BUSINESS TROUBLE

A general drastic decline in business fixed investment, as just mentioned, was one of several ominous features of the GDP growth reported for the third quarter. Ever since, bad corporate news of profits and sales are proliferating. One after the other, the pillars of the vaunted U.S. economy have been shaken. No organization seems safe anymore. J.P. Morgan & Co., a few years ago the most prestigious commercial bank in the world, decided that it could no longer survive on its own. The CEOs of Coca-Cola, Gillette, Xerox, Procter & Gamble, all prototypes of the global American corporation, give up suddenly or are fired. Numerous dot-com businesses

are filing for bankruptcy. Medium-sized companies are putting themselves up for sale, saying they cannot compete with global behemoths, while the behemoths complain about currency troubles. Profit warnings are the order of the day. Stocks of many stalwarts have dropped 50% or more.

If the economy is in such splendid shape, why is all this bad news suddenly coming together in such an explosive way?

Sharp cutbacks in business fixed investment, as explained, mainly accounted for the surprisingly slow GDP growth in the third quarter. Observing the rising tide of profit warnings, further corporate curtailment of capital investment looks a safe bet. The other big hazard for the economy is the big build-up in business inventories. In the last two quarters it has effectively been of such scale that its mere stoppage would almost guarantee a recession.

Still, despite all these bad news items from single companies, there seems to remain utter complacency about the economy's prospects. Hasn't it been hammered into people's heads that the U.S. economy is healthy as never before? All these profit troubles reported by corporations are either "company-specific" or related to the weak euro. In the case of Europe, just as oddly, the pattern of corporate news versus prevailing perception of the economy as a whole is diametrically opposite. Bad news from single corporations is a rarity, except for cases like Daimler, which bought big problems in the United States. Yet the perception that the European economy as a whole is in many ways lagging the U.S. economy remains well alive in the media and in the markets. Look at the dollar.

GOODBYE TO FREE-FLOWING CREDIT

If the sudden, rapid slowdown both of consumer and corporate spending appears awesome, even more awesome is the speed with which the American financial system has shifted from unfettered credit excess to a nascent credit crunch, even though excess reserves of the banking system are at a higher-than-usual level. Evidence of a developing credit crunch is all of a sudden everywhere.

What's behind the shift? Given the ample supply of bank reserves, it's obviously not Fed action that has caused this dramatic change in the financial climate. Its apparent main cause must essentially be a fundamental reassessment of risk throughout the economy, triggered by escalating, alarming news of bond defaults and bad bank loans. On Oct.16, Bank of America reported a sharp decline in third-quarter income as nonperforming loans had jumped nearly 50%. The next day, Chicago's Bank One reported a 37% drop in earnings in large part for the same reason. Losses from large syndicated loans by U.S. banks so far have more than tripled this year to about $5 billion. That's higher than in the last recession. New bank lending has slowed to a crawl.

Just as bad, if not a lot worse, is the situation in the other lending channel of the financial system: the capital markets. The junk-bond market has collapsed, with yields at their highest level in a decade. Actually, a growing number of investment-grade bonds are trading as if they are junk. As stock prices drop, dealers and investors quickly mark down the value of related bonds as well.

According to S&P, corporate debt downgrades have vastly outnumbered upgrades for nine quarters. Recently, the manager of the world's largest bond investment fund declared that he would avoid corporate bonds "at any cost" because deteriorating credit quality would lead to many more "debt defaults." For many companies, each and every avenue for credit is being closed. Not surprisingly in view of the rout in the stock market, the situation is just as bad for equity financing. More and more IPOs have to be "postponed."

For the time being, it looks like a slow-motion credit crunch, but wait until the markets awaken to the probability of a hard landing. While policymakers and investors yearn for a cooling economy to prevent rising inflation and fend off future Fed rate hikes, they are unprepared for the havoc that a sharply slowing economy

will play with corporate earnings—and with America's extremely vulnerable financial system.

FIGHTING OR HIDING INFLATION?

With some amazement, we often read laudations on today's central bankers in general and Mr. Greenspan in particular: what a great job they have done in fighting inflation. That's utter nonsense. Looking at the unprecedented money and credit explosion that has taken place virtually around the world during the past few years, it should be patently clear that the low inflation rates have absolutely nothing to do with our central bankers. We have these low inflation rates *in spite of them.*

Yet to us, America is the great puzzle. We are at a complete loss to reconcile current inflation rates of 3-4% with the trumpeted productivity miracle. As we have repeatedly stressed, these rates are, actually, exceptionally high in the present global environment. On Oct. 3, the Fed left rates unchanged, despite an inflation rate of 3.4%, with the argument that inflation remains under control and that higher productivity will keep it in check. In Europe, inflation is 2.5%. Yet a few days later, the European central bank raised its interest rate by a quarter to 4.75% because it regards this inflation rate as too high. Core inflation since end-1999 has edged up from 1.1% to 1.3%, as against 2.6% in the United States.

Assessing the U.S. inflation rates, allowance has to be made for the fact that the statisticians have worked hard to trim the measured inflation rate. The first significant downward adjustment occurred in 1996 on the recommendation of the Boskin Commission, which had concluded that America's inflation rate was overstated by an annual 1.1 percentage points. It is reported that about half of this has been "corrected." But further, far more substantial downward adjustments in the price indexes have resulted from the spreading use of "hedonic" pricing methods, used to translate quality improvements in products into price declines.

As this measuring technique is being extended to a growing number of goods, it has become a most important factor in reducing the U.S. inflation rate, which intrinsically raises real GDP growth. Its overall effect is kept a secret, except for computer hardware and software. As we have often enough reported, the hedonic price adjustments for the two alone go a long way to explain America's growth and productivity miracles of the last few years. We think they explain them fully.

Another device to lower the measured U.S. inflation rate is the shift to "chained" price indexing, used since 1996. It changes the weight of items in the basket of goods on the assumption that people generally tend to shift their spending to cheaper goods. If the price of apples rises, people buy more pears, whose lower prices go into the price index instead.

All in all, it seems a reasonable guess that American inflation would now be close to 5% on the old basis, the highest in more than 10 years, and virtually twice the rate in Europe. Inherently, this would cut real GDP growth by about 1.5 percentage points. All this suggests two important things: *first,* that the reported new paradigm increases in real GDP and productivity growth are a statistical illusion; and *second*, that real interest rates are far too low, which also explains the most rampant money and credit creation that the United States has ever seen.

In hindsight it is glaringly clear that the "hedonic" price indexing, by keeping the inflation rate significantly lower than otherwise, has played a key role in fueling the stock market boom. First of all, it delivered the necessary froth for the perception of economic miracles happening to the U.S. economy. Second, and most important, the resulting lower inflation rates gave Mr. Greenspan the green light that he wanted and needed to pursue his reckless policy of vastly excessive monetary looseness. An inflation rate 1-2 percentage points higher would have compelled him to prick the bubble with tighter money long ago—which would have been best for America and the rest of the world.

The true, key source of this fateful boom and the bubble is all too conspicuous in the monetary data. Since 1995, broad money has increased a stunning $2.6 trillion, or 60%. Total credit supply has surged $9.3 trillion, or 54%, to $26.5 trillion. But the most violent crescendo has taken place since late 1998, after the Fed's easing in the wake of the Asian-Russian crisis. Broad money in the short span of time since then has virtually exploded by $1.5 trillion (27%) and overall credit supply by $5.3 trillion (25%). Compare these astronomical money and credit figures with annual nominal GDP growth since end-1998 of around $775 billion.

STATITISCAL VERSUS ECONOMIC EFFECTS

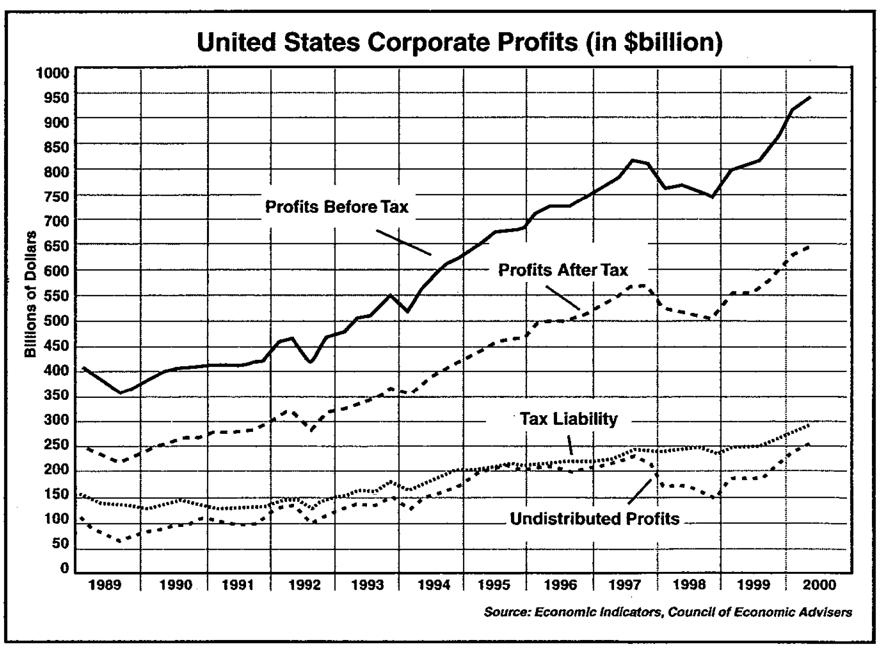
It seems a plausible idea to adjust prices for quality improvements. As we have said before, it may be excellent statistics, but it's definitely lousy economics. The value of more computer power exists not in their possession but in the income effects deriving from their production or their use. In the same vein, it is the essence of productivity growth that it conditions a corresponding rise in overall, real incomes in the business sector, showing partly in higher wages and partly in higher profits.

But where are the rising incomes and profits in the case of hedonic price adjustments that capture quality improvements with price declines? While the hedonic price indexing of computer production has been creating fabulous gains in GDP and productivity, it neither creates actual income or revenue. There is zero addition to national income.

What has the supposed productivity miracle done to real wages? Consulting the Labor Department's figures about "average gross weekly earnings" in 1982 dollars, we note for the 10 years since 1990 an overall increase from $259 to $271. This was a gain of 4.6% over the whole period, or less than half a percent per year. In fact, this increase was concentrated in the last few years, following a prior, long decline since 1974. The first rise took place in 1995, since then cumulating to 6%, or 1.2% annually. Though the strongest wage performance for more than 30 years, it grossly lagged the stellar productivity gains reported for these years. Viewed against this background, one looks for a profit "miracle."

And what has the supposed productivity miracle done to corporate profits? Wall Street hype has it that these were indeed years of unprecedented, phenomenal profitability for U.S. businesses. Year-on-year earnings growth of 20% and higher has been reported for years and over time been taken for granted. Still, this Wall Street boast never had the slightest similarity with reality. Let's take a closer look. See the chart at below.

Total profits of nonfinancial domestic industries are up 150% since 1990, or 15% per year. But isn't 15% annually also an excellent performance, in particular in comparison to annual GDP growth of 7%, implying that profits take a rapidly growing share of national income? Again, it needs a closer look to recognize the inherent gross delusion: The main source of the prolonged profit improvement during the 1990s was a sharp decline in the corporate interest bill.



To give an idea of its impact: In 1990, corporate interest costs accounted

for 6.3% of national income, in 1995 for 3.7% and in 1998 for 3.3%. This decline has actually provided two-thirds of the profit advance over this period. Remarkably, it has continued irrespective of exploding corporate indebtedness. Corporate net interest payments are now at their lowest as a ratio of national income since 1970. For more, see our more detailed expositions (including table) about the U.S. profit performance since 1996 in the last letter.

SYSTEMATIC DELUSION

We have repeatedly highlighted this startling gap between prevailing perception of unprecedented U.S. corporate profitability and effective poor reality. The prolonged existence of this gap is the true miracle, testifying to Wall Street's enormous power and aptitude to delude investors and the public. The methods used to this effect, among them the stereotype fixation on *expected profits per share* as the measure, were easy to recognize, but thousands and thousands of economists and analysts in the investment community were willing accomplices in hiding them. Few, very few, of them endeavored with great caution to express opinions that were not fully in line with the Wall Street hype.

We see here a diametric difference of the position and task of the bank economist of past commercial banks, by the way. He—of whom we were one—was an important part of a bank's public relations arm. His primary task was macroeconomic research with the aim to advise the bank's management and win positive acclaim and attention for the bank among the public by publishing reports. Principally and most importantly, all activity focused on macroeconomic questions and in its wake on monetary and fiscal policy. Market research was confined to currencies, commodities and credit markets. Stock markets were of no interest from a macroeconomic perspective. In Europe, where investment banking has always been integrated with commercial banking, the predominantly micro-oriented stock market analysts were attached to the investment branch in strict separation from the economists devoted to macroeconomic research.

Today, the stars among private sector economists domineering public discussion and public opinion are the investment banking economists who have completely different positions and tasks. Their difference to the traditional bank economist begins with the fact that their interest and knowledge in macroeconomics is generally around zero. They know perfectly well that they are part of the sales force of their employer and that their presumed research has one single purpose: to drum up the sales and the prices of securities. What's more, the sales efforts are taking place with unprecedented aggressiveness.

The chief qualification of these so-called economists is not their analytical acumen, but their ability to bring business to their employer with buy recommendations for stocks and bonds. Besides, the analyst who dares to depart from the bullish consensus is well aware that he is putting his job on the line. Never before has economic "research" been so corrupted. As long as stock prices rose, the great majority didn't care about the truth. Honest, critical economic research virtually disappeared. The few economists who warned were ridiculed.

SILENT ACADEMIA

Another thing that strikes us is the total absence of any macroeconomic discussion. In the 1980s, the measures and declared targets of Reaganomics incited a lively public discussion about its merits and problems with a rich crop of books in which American economists fought their differing opinions out. Today, academic America is silent as a grave on the questions of the New Economy, although the stakes are far greater than in the 1980s with Reaganomics. What has academia to say about negative personal savings? What about the monstrous current-account deficit? Nothing, literally nothing.

Though we see systematic delusion of investors and the public through these stock market-related economists and analysts, we don't think it is deliberate delusion. The problem is they are children of the Great Information Age, meaning they rely on second-hand, selective and condensed information through the

computer, provided by information services like Reuters, Bloomberg and Datastream.

What these economists or analysts know is the limited knowledge that these services and the media disperse. Very, very few care to take a look at the publications that publish the full, original data. Most of them wouldn't even know where to look. In any case, it doesn't pay to have an independent, critical opinion. People like us are simply a fossil of the pre-Information Age, when you were forced to go individually to the source of all data to inform you. Still doing so, we unearth lots of important things that the great majority of the consensus economists fail to see. In addition to full information, however, something else is needed to make the best use of the available data: a theoretical concept of how the economy works. It seems to us that economic theory is another thing that is in short supply.

CONCLUSIONS:

Evidence of a conspicuous, global economic slowdown is now everywhere: in the economic data and in the different markets. Japan and a number of major countries in Asia and Latin America are in big trouble. The biggest threat to the world economy definitely looms in the unsustainable excesses and imbalances that have accumulated in the U.S. economy and its financial system. Credit tightening by the markets and the banks is accelerating the U.S. economic slowdown. All-important variables have turned down together.

It is high time to look at the American and the European economy through a different prism. Prevailing perceptions are hugely distorted by Wall Street propaganda. "Europe's economic fundamentals are under-appreciated in the markets just as much as America's are overblown." This is a quote from a recent article in the London *Economist*: "There once was an ugly duckling"—that became a swan.

Despite the highly adverse news-flow, deep-seated confidence remains absurdly excessive. The U.S. forecasting fraternity has yet to predict anything less than the 3% to 3.3% soft landing for 2001. Profit forecasts are just as ridiculously high. If the growth pattern of the third quarter does prevail as we think, the U.S. economy's hard landing has already arrived, implying zero real growth or less in the current fourth quarter.

The dollar's crash is a disaster waiting to happen. There is but one safe haven in the global financial markets: first-class European bonds. American investors will make huge capital gains on the currency.

After all, it's back to basics in the stock markets. Earnings and risks matter again. There are two shocks waiting out there: a profit shock and a dollar shock.

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